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DIRECTORATE OF
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The Short-Term Impact of the Exchange Rate Changes

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CENTRAL INTELLIGENCE AGENCY
Directorate of Intelligence
December 1971

INTELLIGENCE MEMORANDUM

THE SHORT-TERM IMPACT OF THE EXCHANGE RATE CHANGES

Introduction

1. After several months of negotiations the Group of Ten financial powers -- joined by Switzerland -- agreed on 18 December 1971 to realign their foreign-exchange rates. The continuing impasse had engendered fears that instability in foreign-exchange markets and increasing restrictions on trade and capital flows would precipitate a retreat into protectionism and isolationism. Moreover, uncertainty had begun to inhibit investment and trade commitments, threatening to worsen the general economic downturn in Western Europe and Japan and to hamper economic recovery in North America. The agreement gives promise that the United States will be able to approach a balance in its international payments, and it creates a more favorable atmosphere for international negotiations on the outstanding issues the President enunciated on 15 August. This memorandum assesses the near-term impact of the agreement, particularly on the United States, Japan, West Germany, Canada, and the European Community (EC).

Discussion

The 18 December Agreement

2. The agreement reached by the Group of Ten (the United States, Belgium, Canada, France, Italy, Japan, Netherlands, Sweden, United Kingdom, and West Germany) and Switzerland ended a four-month period of floating exchange rates and general monetary uncertainty. The basic feature of the currency realignment is a 7.9% devaluation of the US dollar

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relative to gold. In addition, France and the United Kingdom agreed not to alter their currencies' value in terms of gold and other countries altered their parities to varying degrees. In exchange, the United States agreed to end the import surcharge immediately and drop the buy-American provision of the investment tax credit. The US concessions were made in the expectation that there would soon be satisfactory progress in negotiations over some short-term trade issues.

Impact of Agreement

General

3. The currency realignment should improve the US merchandise trade account substantially. Taking into account the upward currency revaluations contributed by five major US trade partners – especially the rise of 4.6% and 7.7% in terms of gold for the German mark and Japanese yen, respectively – the dollar's weighted average devaluation against all other currencies is nearly 10% (see Table 1).* The improvement in the US trade balance may be slow in coming, owing to the economic slowdown abroad (which will hold down US exports), the economic recovery in the United States (which will stimulate US imports), and lags before the parity changes are fully reflected in their trade balances. Nevertheless, the devaluation should improve the US trade account by several billion dollars annually within about two years. Using a CIA modification of the International Monetary Fund trade flow model, the eventual improvement is calculated at about $8 billion annually.

4. About three-fourths of the US trade improvement will probably come at the expense of Japan, which is revaluing about 11% in relation to the rest of the world, and of West Germany, revaluing more than 6%. Although the Canadian dollar continues to float, it remains close to the US dollar. If something like this exchange rate continues, it will mean an appreciation for Canada's dollar from its pre-float parity in May 1970 of nearly 8% relative to the US dollar and 4% overall.

5. Other elements of the US current account also will be affected by the new exchange rates. Expenditures on travel, for example, are about as responsive as trade transactions to exchange rate revisions. Income from foreign investment is relatively insensitive over the short run to such changes.

* The estimates of effective overall revaluation or devaluation are derived using the average geographic distribution of each country's trade in 1966-68. Countries other than the Group of Ten nations, Austria, Denmark, Norway, and Switzerland are assumed to adjust their parities so as to maintain their current trade balances and are lumped together as a group.

Table 1

Percentage Change in Currency Values from May 1970

	Relative to the US Dollar	Relative to Gold	Relative to Trade Partners a/
Belgian franc	11.6	2.8	3½
British pound	8.6	No change	1
Canadian dollar	Nearly 8.0	Continues to float	3½
Dutch guilder	11.6	2.8	3
French franc	8.6	No change	Negl.
Italian lira	7.5	-1.0	-1
Japanese yen	16.9	7.7	11
Swedish crown	7.5	-1.0	-1
Swiss franc	13.9	4.9	5½
US dollar	--	-7.9	-9½
West German mark	13.6	4.6	6½

a. *Estimates based on 1966-68 market shares.*

But over the longer term, the appreciation of other currencies may reduce the profitability of US foreign investments and so dampen the growth of investment income.

6. The currency realignment and the expected resurgence of the US economy should make both direct investment in the United States and US securities more attractive to foreign investors. This, in conjunction with the cyclical downturn in Europe should produce a substantial inflow of capital.

7. In addition, the new exchange rates should end the extensive currency speculation and hedging that has persisted since last spring and should bring an unwinding of earlier speculative transactions. Profit-taking by speculators and multinational corporations will for a time increase the private demand for dollars, thereby reducing the large stores of unwanted dollars in foreign central banks. This may not occur immediately, however, because several European countries must first relax the controls on capital movements that were instituted to discourage speculative dollar inflows. Even in Japan and France, where controls have been tight, capital inflows have been substantial in the disguised form of accelerated dollar receipts and postponed dollar payments for trade and service transactions. These leads and lags will now be unwound.

Japan

8. The effective revaluation of the yen of about 11% overall and 17% relative to the dollar will have appreciable, long-term effects on Japan's economic development. Since sales abroad have been made more difficult, Tokyo will have to rely less on export-oriented growth. Some shift in exports away from the US market will also occur. But these changes will take years. In the short-term, Japanese exporters will largely maintain the existing sales pattern despite the yen's appreciation. They will be able to raise dollar prices in many cases without much loss in sales volume, and they will cut profit margins where necessary.

9. More important for the short-term trade outlook is the expansion rate of the Japanese economy. When the present slowdown ends and an upturn occurs, imports will increase sharply and the trade surplus will be reduced. Such an economic upturn is not expected until at least the spring of 1972, but it probably will occur long before the full impact of the revaluation has been manifested on trade.

10. In the immediate future, the currency realignment will likely have its largest impact on Japan's short-term capital flows. During the past nine months, net short-term capital flows into Japan amounted to at least $5

billion, most of it a hedge against the yen's revaluation. A large part of these funds – which typically were borrowed abroad, especially in the United States – are now expected to flow out.

11. Japanese foreign exchange reserves are ample to cover any likely capital outflows (see Table 2). The trade and current-account surpluses, which reached nearly $8 billion and more than $5 billion, respectively, in 1971, will decline in 1972 and beyond. Trade deficits are unlikely in the next few years, although current-account deficits are possible.

West Germany

12. Even though settlement of the currency crisis probably will give a boost to business confidence, West Germany's short-term prospects are for little economic growth. Anti-inflationary government policies have resulted in an economic slowdown without, as yet, markedly slowing inflation. The prevalence of excess productive capacity and low profits has depressed private investment.

13. The currency realignment further appreciates the mark in terms of the dollar but reduces its appreciation relative to key European currencies, notably the French franc, Italian lira, and British pound. Overall, the mark has been appreciated about 6-1/2%. The new currency relationships probably will generate a large outflow of short-term capital, but since official reserves are at a record high of $17 billion, this should not cause serious problems for the German economy. Over the longer term, however, the mark's new appreciation, on top of the 9% appreciation in 1969, could considerably worsen the trade balance and will probably lead to a current-account deficit.

France

14. The effects of the new US economic policy on France were basically psychological. Gloomy forecasts of an imminent trade war and depression in Western Europe caused the postponement of several major investment projects; unemployment appeared to be increasing rapidly; and the French stock market plummeted. Last week's agreement – by ending economic uncertainty – will do much to restore needed confidence.

15. It appears that the new exchange rate alignment will have virtually no long-run effect on France's competitive position in foreign trade. The improvement in its competitive position relative to West Germany, Belgium, the Netherlands, and Japan will in general be offset by the devaluations in the United States, Italy, and Sweden, relative to the franc. Like West Germany and Japan, France faces an immediate, substantial loss of

Table 2

Comparative International Accounts

Million US $

	Trade Balance 1970 a/	Current Account Balance 1970	Basic Balance 1970 b/	International Reserves Oct 1971
Belgium/ Luxembourg	788	744	464	3,333
Canada	3,509	1,243	2,022	5,071
France	702	251	613	7,272
Italy	-340	814	2,190	6,624
Japan	3,963	1,970	379	14,100
Netherlands	-884	-474	39	3,590
Sweden	315	-317	-170	998
Switzerland	-835	65	N.A.	6,528
United Kingdom	7	1,390	907	5,210
United States	2,110	444	-3,038	12,146
West Germany	6,760	681	-415	17,179

a. *Exports f.o.b., imports f.o.b.*
b. *Current account plus long-term capital.*

speculative capital that flowed into the country this past summer and fall. This outflow may reach as much as $1 billion.

Canada

16. It appears unlikely that the Canadian dollar – which has floated since May 1970 – will be repegged in the near future. Ottawa plans to let its dollar float down, expecting that it will eventually find a sustainable level slightly below parity with the US dollar. If this happens, its relationship to the US dollar will change little from that existing before realignment. Elimination of the US import surcharge and buy-American provision of the investment tax credit – both of great concern in Canada – should considerably brighten prospects, thereby stimulating consumer spending and business investment. In the longer term, however, the appreciation of the Canadian dollar could reduce Canada's trade surplus by almost $1 billion.

Other Group of Ten Countries and Switzerland

17. Only two of the other Group of Ten countries – Belgium and the Netherlands – along with Switzerland will experience a substantial appreciation of their currencies relative to their trading partners. In contrast, Italy and Sweden will improve their trade competitiveness. Although sterling appreciated slightly overall, it has been devalued in relation to the EC countries, a move that will reduce the cost of UK entry into the EC.

Rest of the World

18. The trade of the developing countries will be little affected by the currency realignment. Many of them will devalue by an amount equal to that of the dollar; Mexico, Brazil, Taiwan, Thailand, and Indonesia have already chosen this course. Others – such as Hong Kong, Rhodesia, Malaysia, Singapore, and Saudi Arabia – have chosen to stay with their old gold parities. A number of other countries have taken different routes. Denmark, Finland, and Norway remain keyed to the Swedish crown, devaluing 1% with respect to gold. India has devalued by approximately 5.5% and South Africa by 12.3%, both relative to gold. In the latter instance, Pretoria, by devaluing even more than the US dollar, has provided a new impetus to the South African gold industry – the source of three-fourths of non-Communist gold production – that is hard pressed by rising production costs. One almost certain result of the realignment is that the Organization of Petroleum Exporting Countries (OPEC) will demand an increase in the oil price now quoted in dollars. OPEC will meet with the major oil companies on 10 January and will probably ask for a price increase of about 12%. There will be no direct economic impact on the Communist countries. The USSR is maintaining the gold content of the

ruble, which, in effect, upvalues it in terms of the dollar, but this is essentially a bookkeeping convenience.

EC Issues

19. With the return to fixed exchange rates, the EC should be able to resume the discussions on monetary union that were interrupted last May by the German and Dutch currency floats. Whether there will be early progress toward the agreed goal of economic and monetary union remains problematical. The widening of permissible exchange-rate fluctuations under the new agreement runs counter to the narrowing of margins sought by EC members for intra-EC transactions, although narrower margins among EC currencies are not precluded. Fundamental differences in point of view among the EC countries – in particular the French preference for controls over capital flows and German preference for a free capital market – have not been removed by the international monetary upheaval and exchange rate realignment. Nevertheless, the fuller understanding of problems and positions brought about by the crisis should promote a more realistic and perhaps ultimately more fruitful approach to monetary union.

20. More immediately, realignment will force the EC to make politically difficult adjustments in its Common Agricultural Policy (CAP). Under CAP, agricultural prices have been stated in terms of a unit of account equivalent to a specified amount of gold that is translated into national currencies at parities established with the International Monetary Fund. Preservation of existing CAP prices would entail a reduction in farm prices in Germany, Belgium, Luxembourg, and the Netherlands because the gold content of their currencies has risen. There would, however, be no change in France and a 1% increase in Italy. Germany clearly will resist any further reduction in farm prices for political reasons. When the Germans floated the mark in May 1971, they introduced a system of compensatory import duties and export subsidies that enabled them to avoid reducing farm prices and, consequently, farm incomes. Bonn apparently favors retention of this compensatory system, even though it involves a deviation from free intra-EC trade. Other solutions, which might be used in combination with one another, include a revaluation of the unit of account or a general increase in EC prices in terms of this unit, direct income subsidies to farmers, and subsidies to farmers in the form of increased value-added tax refunds.

Some Unresolved Issues

21. The recent Group of Ten meeting in Washington did not attempt to reform the basic structure of the international financial system, a process that will require negotiations possibly lasting a year or more. The most pressing problem now facing the international financial community is that

of determining the mix and value of reserve assets. The major countries, including France, apparently are convinced that gold's contribution to international liquidity will be reduced. Consequently, alternative forms of international liquidity will have to be designed.

Conclusions

22. The 18 December agreement to realign exchange rates among the Group of Ten countries and Switzerland eventually will strengthen the US balance of payments considerably. Within two years, an improvement in the US trade balance of several billion dollars, at a minimum, can be expected. The settlement is largely at the expense of West Germany and Japan and may eventually result in current-account deficits, at least in Germany. But Germany and Japan have the world's largest reserves. Canada's exports of manufactures will be adversely affected if the Canadian dollar continues to float nearly 8% above its May 1970 parity relative to the US dollar. British and French trade will be little affected by the exchange rate changes. There will be an early reflux of short-term capital into the United States as last spring's massive outflow is wound down.